United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1617

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IN THE

United States Court of Appeals

For the Second Circuit

P/S

ESTATE OF DAVID SMITH, DECEASED, IRA M. LOWE, CLEMENT GREENBERG, ROBERT MOTHERWELL, Co-executors,
Petitioners-Appellants,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the United States Tax Court

BRIEF FOR PETITIONERS-APPELLANTS

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July 8, 1974

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This is an appeal from a decision of the United States Tax Court. Trial of the case was held before the late Judge Kern. The decision of the Court was rendered by Judge Tannenwald. His opinion is reported at 57 T.C. 650 (1972). The full majority, concurring and dissenting opinions below are reproduced at pages 72a through 96a of the joint appendix filed herewith.

Statement of the Issue Presented

Whether the Tax Court erred in holding that the Federal estate tax deduction under section 2053(a) of the Internal Revenue Code of 1954[1] and the Treasury Regulations thereunder for commissions paid upon sales of estate property is limited to the exact amount necessary to raise cash to meet other administration expenses, debts and finally adjudicated tax deficiencies, rather than the full sales commissions allowed as necessary and proper estate administration expenses by the state probate court having jurisdiction over the estate.

Statement of the Case

This is an appeal by the Estate of David Smith (hereinafter, the "Taxpayer" or "Estate") from that part of a decision of the United States Tax Court disallowing the Estate's deduction as administration expenses under section 2053(a) of certain commissions paid the Marlborough-Gerson Gallery Inc. (hereinafter, the "Gallery") upon sale by the Gallery of sculpture owned by the Estate.

The decedent, David Smith, died on May 23, 1965. Pursuant to decedent's last will and testament, Ira M. Lowe, Clement Greenberg, and Robert Motherwell were appointed co-executors (hereinafter, the "Executors") (R, 72a).[2] The Estate filed a Federal estate tax return with the Dis-

1. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

2. "R" references are to the parties' separately bound joint record appendix, filed herewith.

trict Director of Internal Revenue in Albany, New York, on August 24, 1966 and paid $198,045.98 in Federal estate taxes. Subsequently the Estate paid additional taxes of $46,449.67. On August 7, 1969, the Commissioner of Internal Revenue issued a statutory Notice of Deficiency in the amount of $2,444,629.17, resulting from an increase in the valuation of the 425 pieces of decedent's sculpture owned by him at his death (R, 9a). On August 21, 1969, the Estate filed a petition in the Tax Court seeking a redetermination of the deficiency (R, 4a) which was amended on October 20, 1970 (R, 11a). The case was heard by the Tax Court on October 26 and 27, 1970.

The Tax Court, in its Findings of Fact and Opinion filed on February 23, 1972, held that the value of the 425 pieces of sculpture was $2,700,000 and, over the dissenting opinion of five judges, that the Estate's deduction under section 2053(a) for commissions paid the Gallery was limited to that amount paid in order to obtain the exact amount of cash necessary to meet other administration expenses, debts and finally adjudicated tax deficiencies.

On April 25, 1974, the Estate filed a notice of appeal to this Court on the issue of the proper amount of the deduction under section 2053 for commissions paid the Gallery. The value of the sculpture is not a subject of this appeal (R, 101a). Jurisdiction is conferred on the Court by section 7482.

The material facts, relevant to the issue appealed to this Court, are as follows:

David Smith, a sculptor, died on May 23, 1965. His last will and testament (hereinafter, the "Will"),[3] dated January 21, 1965, was admitted to probate by the Surrogate's Court of Warren County, New York, the court having jurisdiction over the Estate (R, 12a), and letters testamentary were issued by the Court to the three Executors. The Will provided in pertinent part as follows:

> "FIRST: I order and direct my Executors hereinafter named, to pay all of my just debts and funeral expenses as soon after my death as may be practicable. I also direct my Executors to pay all inheritance and estate taxes, and all other governmental charges, taxes or liens upon my estate . . .
>
> * * *
>
> "SECOND: I hereby give, devise and bequeath all the remainder of my property including real and personal and all works of art including sculpture, paintings, drawings and any and all other forms of art of which I die possessed or which I may own or have any interest in at the time of my death to the Trustees, hereinbelow designated, IN TRUST NEVERTHELESS FOR THE FOLLOWING USES AND PURPOSES:
>
> "To divide the same into two separate and equal parts or shares, one for each of my children, Rebecca and Candida, and the Trustees shall hold one of the said parts or shares as a separate trust for each of said children.
>
> * * *
>
> "THIRD: My Executors and Trustees shall take possession of my estate and are hereby given power to hold, manage, operate, control, sell, convey, lease,

3. The entire will is reproduced at pages 22a through 26a of the appendix.

mortgage, encumber, renew encumbrances, and assign the said estate, or any part thereof, to collect all the rents, income and profits therefrom; to pay all taxes, insurance charges, necessary repairs and other proper expenses connected therewith; and with full power to sell and convey, from time to time, and to mortgage and encumber such parts of my property and estate, real or personal, including all of my works of art, as in their best judgment and discretion may be expedient. The proceeds derived from any such sale or sales shall be invested and reinvested from time to time in such securities and property, real or personal, as my Trustees may elect.

"In the disposal of my works of art and other property, real and personal, said Trustees shall have as full and unlimited power and discretion as if said trust property were their own absolute estate.

"To determine all questions with respect to the manner in which expenses are to be borne and receipts are to be credited as between principal and income, and all decisions and accounts of the Executors and Trustees shall be binding on all persons in interest, and they shall incur no liability on account thereof unless guilty of fraud or willful negligence."

* * *

Smith began sculpting in 1937. Most of his work is considered abstract, nonrepresentational art and is fashioned out of welded steel and other metals. From 1940 to 1963, Smith was represented by two art galleries which tried to sell his work with little success. On or about June 2, 1963, Smith entered into an agreement with the Gallery which gave it the exclusive right to sell his work for a period of five years and entitled it to a commission of ⅓ of the net proceeds from any piece of sculpture sold (R, 73a to

74a). This contract was renewed by the Executors on June 3, 1968.[4]

Between June 2, 1963 and Smith's death, the Gallery's efforts resulted in a total of five sales of sculpture. During the last 25 years of his life Smith sold only 75 pieces of his sculpture, for a total consideration of $218,080.50. He died owning 425 pieces of his own work (R, 73a to 75a).

While Smith had begun to gain critical recognition toward the end of his life (R, 44a), he had never been commercially successful (R, 75a). This was in part because sculpture is generally more difficult to sell than paintings (R, 52a, 75a). Also, Smith's sculptures were in general quite large; 185 of the 425 works in Smith's possession at his death were over seven feet tall and required a great deal of space to be properly exhibited (R, 76a).

Smith was a prolific sculptor and constantly created more works than the market could absorb. Customarily he produced a series of between 10 and 30 sculptures which were similar in appearance, technique and scale. At the time of his death and for an undetermined period thereafter, the general public was unaware of the number of Smith's works in his possession at the time of his death (R, 76a to 77a).

Apart from his sculpture, Smith left cash and other liquid assets reducible to cash in the amount of $210,-

4. On July 1, 1970, subsequent to the Tax Court proceeding and therefore not stipulated or found by the Court, the Executors renewed this contract again for a three-year period. The new contract provided for a commission equal to 30% of the amount on each item sold up to and including $38,000 in value and 25% of the amount received on each item sold from $38,001.

647.08 (R, 18a, 78a). There were other minor illiquid assets such as equipment, sketches and the real property on which much of the sculpture was located. The overwhelming bulk of the Estate consisted of Smith's own sculpture, the value of which was extremely speculative. The Executors valued the sculpture at $714,000 (R, 77a). The Commissioner valued the sculpture at $5,256,918 in his Notice of Deficiency (R, 13a). The Tax Court valued the sculpture at $2,700,000 (R, 79a).

Shortly after Smith's death, the Executors began an orderly process of gradual liquidation through the Gallery of the Estate's holdings of sculpture. Had the Estate offered all 425 pieces for sale immediately, the Estate could have expected to receive substantially less money for the works than if they were slowly disseminated in the market over a period of years (R, 77a). These sales resulted in a steady payment of commissions to the Gallery during the period May 23, 1965 through March 31, 1970 (R, 14a). From Smith's death through the end of the Executors' Second Intermediate Accounting, April 30, 1970, an aggregate of $1,187,144.67 of commissions paid to the Gallery was allowed by the Surrogate's Court of Warren County, New York (R, 78a). (Further commissions of $396,400 were paid by the Estate to the Gallery during the period May 1, 1970 through August 21, 1973 and all such commissions have been allowed by the Surrogate's Court of Warren County. The Executors presented a total of five accounts to the Surrogate's Court, including the two before the Tax Court and their third and final account, which had two supplements. The decree of the Surrogate's Court approving the final account of the Executors was dated August 21, 1973. While evidence as to these supplementary commissions of $396,000

is not in the record, the total sum of $1,602,644.67 represents the full amount of the deduction sought by the Estate.)[5]

From May 23, 1965 through April 30, 1970, the Estate was required to pay $789,970.38 for various administration expenses other than the Gallery's commissions and for debts of the decedent and taxes (R, 78a). The Tax Court allowed a deduction for commissions under section 2053 of $289,661.65, representing the precise amount of commissions which would have been necessary to realize $579,323.30, the difference between the Estate's obligations of $789,970.38 and its cash of $210,647.08 (R, 78a).

Under the Rule 50 computation, the Tax Court allowed the Estate further deductions in respect of the Gallery's commissions of $410,012.52, representing the precise amount of commissions necessary to realize the $671,452.93 of final Estate administration expenses during the period May 1, 1970 through August 14, 1973,[6] and of $50,773.57, representing the precise amount of commissions necessary to realize the $71,433.51 of Federal and New York estate tax deficiencies, together with interest, resulting under the computation.

Thus the Tax Court decision would allow the Estate a total of $750,447.74 in deductions under section 2053 in

5. Pursuant to paragraph 15 of the parties' First Supplemental Stipulation of Facts (R, 15a) and Rule 156 of the Rules of Practice and Procedure of the United States Tax Court, upon remand by this Court, evidence as to these supplementary commissions can be stipulated by the parties or heard by the Tax Court.

6. As a technical matter, the Rule 50 computation (R, 97a to 99a), Rule 155 as of January 1, 1974, ends as of August 14, 1973, while the decree of the Surrogate's Court ending the administration of the Estate is dated August 21, 1973. The Estate had no expenses in the interim period.

respect of the Gallery's selling commissions. Taxpayer is seeking a deduction of the full $1,602,644.67 in commissions, an increase of $852,196.93.

Summary of Argument

In its opinion below, the Tax Court held that Treasury Regulations §20.2053-3(d)(2) was valid and that the total amount of commissions incurred by the Estate in its sale of decedent's sculpture did not meet the test for deductibility provided by that regulations section. The Court limited the Estate's deduction for commissions paid the Gallery to the amount necessarily incurred in order to raise the precise amounts of cash needed to meet the Estate's other administration expenses, the decedent's debts and the Estate's taxes as finally adjudicated.

The Tax Court erred in not allowing a deduction for all commissions paid the Gallery. The record below amply demonstrates that all of the sales commissions were deductible within the specific requirements of Treasury Regulations §20.2053-3(d)(2), since such sales were necessary in order to pay the decedent's debts and the Estate's other administration expenses and anticipated taxes, as well as to preserve the Estate and to effect an orderly distribution of its assets. Furthermore, since the propriety of the sales was established by the decrees of the Warren County Surrogate's Court and since the record shows no basis to ignore those decrees under the provisions of Treasury Regulations §20.2053-1(b)(2), the decrees are determinative as to the deductibility of the Gallery commissions for Federal estate tax purposes. If the subject regulations are read to deny a deduction for administration expenses properly allowed

under state law by the court supervising the administration of the Estate, they impose a limitation upon the deductibility of selling expenses which is not contemplated or permitted by section 2053.

Argument

I

The Tax Court erred in holding that all of the commissions incurred by the Estate in the sale of the sculpture failed to qualify as deductible expenses under the express language of Treasury Regulations §20.2053-3(d)(2).

In determining a decedent's taxable estate, section 2053(a) provides a deduction from the gross estate for:

> "[S]uch amounts . . . for administration expenses, . . . as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered."

Treasury Regulations §20.2053-3(d)(2) provides that:

> "Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution."

The Tax Court has erroneously applied Treasury Regulations §20.2053-3(d)(2) in holding that all commissions paid the Gallery by the Estate on sales of sculpture were not deductible administration expenses under this regulation.

The Estate's sale of 219 sculptures through the Gallery during the period May 23, 1965 through August 21, 1973, and payment of resulting commissions, was necessary for

the payment of taxes and administration expenses and was also necessary to preserve the estate and effect an orderly distribution. Accordingly, the commissions are deductible selling expenses under the express language of §20.2053-3 (d)(2).

Both under the provisions of the Will (Article THIRD, R, 24a) and New York law (Section 11-1.1(b)(5)(B) of the New York Estates, Powers and Trusts Law), the Executors had the power to sell the sculpture and acted properly in selling 219 pieces. The issue is only the "necessity" of those sales within the language of the regulations and New York law.

Upon the death of David Smith, the executors named in his will were faced with an estate whose administration would be long and difficult. David Smith had been a prolific sculptor "who produced far more work than the market could absorb" (R, 54a), such that he owned 425 pieces of his own sculpture at his death (R, 72a), having sold only 75 pieces during the preceding 25 years of his life (R, 73a and 75a). Smith had been "constantly crippled by lack of liquidity" during his lifetime (R, 49a) due to his inability to sell large numbers of his sculptures (R, 49a, 50a, 64a). That crisis of liquidity could only worsen upon his death, because the Executors were faced with obligations to pay substantial taxes and administration expenses and the overwhelming portion of the Estate consisted of Smith's own sculpture. The parties have stipulated that the cash available to the Estate as of the date of death or from sale of liquid assets was $210,647.08 (R, 18a). The remainder of the Estate, apart from minor other illiquid assets such as equipment, sketches and the real property on which much of

the sculpture was located, consisted of the sculpture, which Taxpayer valued at $714,000 (R, 77a), the Commissioner at $5,256,918 (R, 5a), and the Tax Court at $2,700,000 (R, 79a). Thus at Taxpayer's value the sculpture represented approximately 77% of the value of the Estate, at the Commissioner's value it represented approximately 95% of the value of the Estate and at the value as finally found by the Tax Court it represented approximately 93% of the value of the Estate.

Not only was the Estate illiquid, it was dependent for its resources upon the sale of David Smith's sculpture, an asset of unknown worth. Robert Motherwell, one of the Executors, testified before the Tax Court concerning the vagaries of the art market in general (R, 47a). The value of David Smith's work was unusually speculative because it was sculpture, which is always more difficult to sell than paintings (R, 52a to 53a, 75a), because much of it (including most of the best pieces) was extremely large, requiring a great deal of space to install (R, 75a to 76a), because it was abstract, non-representational art with a very limited audience (R, 48a) and perhaps most important, because Smith was an artist unknown to the general public at his death (R, 52a) and whose reputation in the art world was not secure (R, 65a to 66a). In short, the Executors in 1965 began the administration of an estate burdened with one asset that constituted the great bulk of its worth, that had an entirely speculative value and that would have to be liquidated in substantial part in the upcoming months and years to meet the obligations of the Estate, which included a tax liability of a large but indeterminate amount.

The Tax Court in its opinion below does not even consider the Executors' duty to prepare for anticipated tax

liabilities. There was no way in 1965, or indeed in 1970, that the Executors could with any precision predict the amount of Federal and New York estate taxes which would eventually be payable by the Estate. Each tax is of course a graduated tax and the value of the asset constituting the bulk of the Estate was unknown. The Executors knew only that there would eventually be substantial taxes payable, and that they would have to sell sculpture to realize the cash.

The majority below itself recognized that hindsight is not intended by the regulations, and that the deduction under section 2053 is limited to those expenses "which could be anticipated as being necessarily incurred and paid during the period of administration" (R, 89a). However, the decision below would limit Taxpayer's deduction to the precise amount of commissions which knowledge available only nine years after death shows to have been "necessary" to meet the minimum obligations of the Estate. No fiduciary can act in such a way. He must anticipate his obligations, as the court below admits.

At an absolute minimum, the Executors were put on notice by the Commissioner's Notice of Deficiency dated August 7, 1969 that they had to be prepared to meet a contingent liability of $2,444,629.17 in additional Federal estate taxes (R, 9a). This was more than ten times the tax paid with the return and more than ten times the amount of cash which the Estate had available for the payment of all of its obligations (R, 78a). If the Commissioner's assessed taxable estate of $5,329,738.54 (R, 9a) had been sustained, an additional New York estate tax of

$570,193.23 would also have been due.[7] Sales to meet these obligations alone, together with appropriate interest charges, would have incurred over $1,750,000.00 in commissions, more than the entire $1,602,644.67 which the Executors in fact paid in commissions and now seek as a deduction.

Faced with these anticipated obligations the Executors began to sell decedent's sculpture. This was not an estate funded with treasury bills, that could be held until the day before an obligation was due and then sold for the precise amount required. The Estate consisted of abstract sculpture, the value of which was extremely speculative but which in any event would take years to sell. The Executors believed, and presented expert evidence at trial to the effect that an auction sale of a large number of Smith's sculptures would have been "sheer disaster" (R, 56a), resulting in substantially depressed prices (R, 60a to 61a). Even the government's own witness agreed that gradual sale over a long period was the best way to sell the sculpture (R, 41a).

Federal law recognizes that expenses incurred in avoiding forced sales for the payment of estate taxes are necessary and proper expenses of administration. *Hipp* v. *United States,* 72-1 U.S.T.C. ¶12,824 (D.S. Car. 1971); *Estate of Henry E. Huntington,* 36 B.T.A. 698 (1937). The Executors could have borrowed funds, as in *Hipp* and

7. The New York estate tax on estates of decedents dying on or after April 1, 1963 is payable under Article 26 of the New York Tax Law. Taxes on a New York taxable estate of more than $5,100,000 and less than $6,100,101 are assessed under Section 952 of that law at $557,000 plus 16% of the excess over $5,100,000.

Huntington, which in this case might have been considered imprudent, or they could have gradually liquidated sculpture. They chose the latter course—a decision clearly within their power—and the expenses resulting are deductible.

In addition to their duty to provide for contingent obligations of the Estate, the Executors were required to do everything in their power to preserve its value, and, as a completely separate matter, commissions paid to this end are deductible as expenses of sales necessarily made to preserve the Estate. The Tax Court in its opinion below found that it was not necessary for the Executors to preserve the Estate because the Will authorized them to distribute all remaining sculpture in kind to the residuary trusts (R, 88a, 22a to 23a). This misconstrues the duties of executors to preserve the value of an estate both under Federal and New York law. An executor has a duty prudently to collect and protect the assets of an estate and where appropriate to liquidate them. See *Adams* v. *Commissioner,* 110 F.2d 578 (8th Cir. 1940). Regardless of the fact that an asset could have been distributed in kind to a testamentary trust, if the Executors determined to sell the asset in the necessary course of their administration, the controlling fact is that they sold it. *Estate of Louis Sternberger,* 18 T.C. 836, 842 (1952), *aff'd,* 207 F.2d 600 (2d Cir. 1953),[8] *reversed on other grounds,* 348 U.S. 187 (1955). Compare *Estate of Streeter* v. *Commissioner,* 491 F.2d 375 (3d Cir. 1974).

Although the Will authorizes the Executors to retain the sculpture and distribute it to the testamentary trusts,

8. The issue of the deductibility of selling expenses was not appealed.

it is evident from the powers given them in the Will (R, 24a) that Smith intended his fiduciaries to sell his sculpture but expected that it would take many years. He empowered both his executors and trustees to sell the sculpture. If the Will had not authorized the Executors to distribute sculpture in kind to the residuary trusts, the Executors would have been required by New York law to sell all of the sculpture after Smith's death, because it constituted a non-legal investment under New York law. See *New York Personal Property Law*, §21; *In re Albro's Will*, 165 Misc. 486, 300 N.Y. Supp. 1103 (Surr. Ct., West. Co. 1937); *Willis* v. *Sharp*, 113 N.Y. 586 (1889).

Furthermore, even though they had authority to retain the sculpture under the Will, the Executors nevertheless were obligated under New York law to administer the sculpture and to sell it when they thought it prudent. *In re Clark's Will*, 257 N.Y. 132, 177 N.E. 397 (1931). The Executors determined that an orderly liquidation of a substantial part of the sculpture was necessary and prudent. Their decision was within their power and the sales were approved by the Surrogate's Court. The commissions are therefore proper deductions as administration expenses incurred for the preservation of the Estate regardless of the fact that the trustees could have made some of the sales. See *Adams, supra* at 583.

The majority below also errs in thinking that unsold sculpture has anything other than a "seasonal" value as contemplated by Treasury Regulations §20.2053-3(d)(2). There was ample evidence in the record of the works of artists which declined in value after their death, such as

Hans Hoffman and Raoul Dufy (R, 45a), and of contemporaries of Smith such as Mary Callery, who was "extremely successful" during her lifetime but whose market has disappeared since her death (R, 55a).

In retrospect, Smith's sculpture has increased substantially in value since his death. But the Executors had no way of knowing that at his death. Holding an asset which was the essence of a speculative asset, whose value might perish overnight, they determined to sell as much as they prudently could to preserve its value for the Estate. The New York Surrogate's Court approved of this decision and found the sales necessary and proper. Expenses incurred in preventing waste are clearly deductible. *Estate of Henry E. Huntington, supra; Brown* v. *Commissioner,* 74 F.2d 281 (10th Cir. 1934).

As the Sixth Circuit stated in *Estate of Park* v. *Commissioner,* 475 F.2d 673, 676-77 (6th Cir. 1973),

> "A prudent fiduciary should be and perhaps is required to prevent the loss of probate assets when it may safely be avoided. If the fiduciary on the basis of his sound judgment, as approved by the probate court, feels that the estate would benefit by the sale of the . . . [asset] (regardless of the wishes of the beneficiaries) the availability of the deductions under §2053(a) should not be denied because the respondent does not deem the sale to have been necessary."

II

The Tax Court erred in holding that the commissions incurred by the Estate in selling the sculpture and properly allowed as administration expenses under State law are not deductible under section 2053(a) of the Internal Revenue Code of 1954.

A. The allowance of all commissions paid the Gallery as administration expenses by the New York Surrogate's Court was determinative of their deductibility under section 2053(a) and Treasury Regulations §20.2053-3(d)(2).

An expense which is properly allowed as an administration expense by the jurisdiction in which an estate is being administered is deductible under section 2053(a) and Treasury Regulations §20.2053-3(d)(2).

As demonstrated above, all commissions paid the Gallery qualify for deduction under the specific requirements of Regulations §20.2053-3(d)(2). However, a detailed inquiry into the requirements of that regulations section by the Tax Court was unnecessary, because Treasury Regulations §20.2053-3(d)(2) is merely a restatement of state law, and as the New York Surrogate's Court reviewed and properly allowed the Estate's sales of sculpture and payment of Gallery commissions, that determination establishes the validity and amount of the commissions as a Federal estate tax deduction. Regulations §20.2053-1(b)(2).

The majority below states that in order for an administration expense to be allowed as a deduction, a taxpayer must demonstrate that the expense has "both been allowed

by the Probate Court and was necessarily incurred to preserve the estate" (R, 88a). The Court thus suggests that the regulations add a requirement that is not present under state law, namely that an expense must be "necessarily incurred". In fact, however, as a matter of New York law, an administration expense must have been "necessarily incurred" in order for it to be allowable in the first place.

Section 222 of the New York Surrogate's Court Act, the provision which governed the Executors, provides:

> "§222. **Payment of expenses incurred by representative.** An executor, administrator, guardian or testamentary trustee may pay from the funds or estate in his hands, from time to time, as shall be necessary, *his legal and proper expenses of administration necessarily incurred by him,* including the reasonable expense of obtaining and continuing his bond and the reasonable counsel fees necessarily incurred in the administration of the estate. Such expenses and disbursements shall be set forth in his account when filed, and settled by the surrogate."[9] (emphasis added)

New York has always required that an administration expense be "necessary" in order for the court to approve

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9. The New York Surrogate's Court Act was succeeded as of September 1, 1967, more than two years after decedent's death, by the Surrogate's Court Procedure Act and the Estates, Powers and Trusts Law. Section 222 is succeeded by Section 11-1.1(b)(23) of the Estates, Powers and Trusts Law (renumbered as of June 22, 1973 as 11-1.1(b)(22)), which provides that a fiduciary is authorized:

> "(23) In addition to those expenses specifically provided for in this paragraph, to pay all other reasonable and proper expenses of administration from the property of the estate or trust, including the reasonable expense of obtaining and continuing his bond and any reasonable counsel fees he may necessarily incur."

The revisers' notes state that the new statute is intended to incorporate the substance of Section 222 of the Surrogate's Court Act.

and allow it upon the fiduciary's final account, the State Court of Appeals ruling, "His duties relate to the property and interests of others, and he is to be indemnified for *necessary* expenses in protecting such trust property" (italics in original). *Downing* v. *Marshall,* 37 N.Y. 380 (1867).

The regulations thus add no new and more stringent requirement of "necessity" in their definition of proper administration expenses; but they do define administration expenses, separately and as a matter of Federal law, to be resorted to by the Federal taxing authorities in those situations where there are no state probate proceedings, as in *Commissioner* v. *Bronson,* 32 F.2d 112 (8th Cir. 1929) and *Pitner* v. *United States,* 388 F.2d 651 (5th Cir. 1967), or where for some reason the state probate proceedings were deficient, as in *Estate of Christine Swayne,* 43 T.C. 190 (1964).

A state probate court will normally examine an executor's claimed administration expenses closely, both to protect the estate's beneficiaries from unwarranted expenses and to protect other creditors from unnecessary expenses.[10]

10. For example, in reviewing the accounts of executors, New York courts have disallowed travel expenses which an executor unnecessarily incurred during the administration of the estate. *In re Estate of Herter,* 15 Misc. 2d 184, 179 N.Y.S.2d 353 (Surr. Ct., N.Y. Co. 1958). They have disallowed excessive funeral and cemetery expenses. *In re De Filippis' Estate,* 113 N.Y.S.2d 724 (Surr. Ct., Warren Co. 1952). They have surcharged executors for incurring excessive stenographic and secretarial charges. *In re Estate of Levine,* 26 Misc. 2d 307, 203 N.Y.S.2d 643 (Surr. Ct., N.Y. Co. 1960). And they have surcharged executors for improperly paying expenses in connection with the administration of property where the recipient of that property should have paid the expenses. *In re Morawetz' Will,* 35 Misc. 2d 762, 231 N.Y.S.2d 1000 (Surr. Ct., Albany Co. 1962); *Estate of Williams,* 71 Misc. 2d 243, 335 N.Y.S.2d 950 (Surr. Ct., N.Y. Co. 1972).

If it allows the expense, the Federal taxing authorities will also allow it. *Dulles* v. *Johnson*, 273 F.2d 362 (2d Cir. 1959), *cert. denied*, 364 U.S. 834 (1960); *Commercial Nat. Bank of Charlotte* v. *United States*, 196 F.2d 182 (4th Cir. 1952); *Sussman* v. *United States*, 236 F. Supp. 507 (E.D. N.Y. 1962); *Schmalstig* v. *Conner*, 46 F. Supp. 531 (S.D. Ohio 1942).

The only situation where reliance upon state probate proceedings cannot be had is where the interests of the state and Federal governments do not coalesce, as where the state had no interests to protect in examining the claimed administration expense. *Pitner* v. *United States*, *supra*. In such a situation, the Federal court may look behind the state court decree, and may reject it if it is clearly unreasonable or at variance with the law of the state. Regulations §20.2053-1(b)(2). This most often occurs where the executor is the sole or major beneficiary under the will, and where he incurs an administration expense for his personal benefit, as in the sale of a residence which he individually does not want. This was the situation in *Estate of Christine Swayne*, *supra*, the case relied on by the majority below, which is completely distinguishable from Taxpayer's case.

In *Swayne*, a Connecticut decedent had left the bulk of her estate, including her home, to her son, who also served as sole representative of her estate. During the administration of the estate, the son instituted a special proceeding in the Connecticut probate court, in his capacity as representative of the estate, seeking the court's approval of the sale of her home. In his capacity as primary beneficiary of the estate, the son "consented" to the sale and on that

basis alone the probate court allowed the sale, as "reasonable". 43 T.C. at 201. The expenses of the sale were later approved as administration expenses by the state probate court when it accepted the administrator's final account, but they were *disallowed* as administration expenses by the same court in the state succession tax proceedings. This way the only evidence before the Tax Court.

Thus the Tax Court in *Swayne* was presented with three separate state court decrees concerning the sale of decedent's house which were inconclusive and which conflicted on the precise point in issue. In this situation the Internal Revenue Service was bound to look behind the state court proceedings, under the terms of Regulations §20.2053-1(b)(2). Once it did look behind the state court decrees, the Tax Court found that the taxpayer had not demonstrated the necessity of the estate's selling the house, either under Federal or state law. The sale had been completed at his wish and consent as the individual beneficiary of the estate. In that situation, the deduction was disallowed.

Absent a situation such as that in *Swayne,* a state court's decision on administration expenses is normally to be followed, without further inquiry by the Commissioner into the facts. The recent decision of the Sixth Circuit in *Estate of Park* v. *Commissioner,* 475 F.2d 673 (6th Cir. 1973), is squarely in point.

In *Park,* the decedent left two houses, which passed to her four sons under the residuary clause of her will. The sons did not want the houses and requested the administrator of the estate to sell them. It did, incurring expenses of sale in the transactions. The Michigan state courts deter-

mined the expenses of sale to have been allowable administration expenses under state law. Because the estate was solvent and the houses did not have to be sold, the Commissioner and the Tax Court disallowed these expenses as deductions under Treasury Regulations §20.2053-3(d)(2). After considering and rejecting the decision of the majority below in *David Smith,* the Sixth Circuit reversed the Tax Court, stating:

> "By the literal language of §2053(a), Congress has left the deductibility of administration expenses to be governed by their chargeability against the assets of the estate under state law. As otherwise stated, Congress has committed to the considered judgment of the states whether a particular expense is allowable as a proper or necessary charge against estate assets. In the situation before us, the expenses were admittedly allowable under Michigan law. They were paid out of probate assets and they were approved in two different accountings filed with the probate court. Hence they are deductible under §2053(a)." *Id.* at 676.

Given the clear necessity of the sales of decedent's sculpture to meet the Estate's anticipated obligations, Taxpayer's case for a deduction is a stronger one than that in *Park.* The point here, however, is that there is no reason to look behind the Surrogate's Court decrees, which were in accordance with New York law. All five accountings of the Executors in which sales of sculpture by the Gallery were reported were judicial proceedings, with all parties represented, including a guardian or guardian ad litem having no personal interest in the estate on behalf of the minor beneficiaries of the residuary trusts. In all five accounts the sculpture sales and resulting Gallery commis-

sions for the period covered were allowed. In such a case Congress has provided in section 2053 and the Treasury Department has stated in Regulations §20.2053-1(b)(2) that state probate court proceedings are to be determinative on the question of whether a claimed expense of administration is to be allowed as a charge against the estate. *Estate of Park* v. *Commissioner, supra; Ballance* v. *United States,* 347 F.2d 419 (7th Cir. 1965); *Union Commerce Bank* v. *Commissioner,* 339 F.2d 163 (6th Cir. 1964); *Estate of Louis Sternberger,* 18 T.C. 836 (1952).

B. If Treasury Regulations §20.2053-3(d)(2) is read to deny a deduction for administration expenses properly allowed by State law, the Regulations section is invalid.

If, as the majority below erroneously suggests, Regulations §20.2053-3(d)(2) adds a substantive condition for deductibility beyond the statute's "threshold" requirement that an administration expense be allowable under state law (R, 88a), the regulation is "clearly outside the scope of the Code and contrary to the intent of Congress" (R, 91a) and must be ignored. *Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501 (1948).

While these regulations have been in effect in substantially the same form since 1919, regulations are not absolute rules of law and should not be followed where they are in conflict with the "design" of the applicable section of the Code. *Dorfman* v. *Commissioner,* 394 F.2d 651, 655 (2d Cir. 1968); *Mitchell* v. *Commissioner,* 300 F.2d 533, 538 (4th Cir. 1962).

A Federal estate tax was first imposed by Congress in the Revenue Act of 1916 and section 2053(a) is derived from section 202(a)(1) of that Act. Section 202(a)(1) provided as a deduction from the gross estate:

> "Such amounts for administration expenses . . . as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered."

The *only* restriction imposed by Congress on the deductibility of administration expenses was that such expenses had to be allowed under the laws of the jurisdiction in which an estate was being administered.

This restriction on deductibility has not expanded over time. It has been recognized that in passing successor statutes Congress imposed only two restrictions, "[f]irst, that the deductions fall within the class of administration expenses or claims against the estate; and second, that they must be such as are allowable under the law of the jurisdiction under which the estate is being administered." *Schmalstig* v. *Conner*, 46 F.Supp. 531, 533 (S.D. Ohio 1942).[11] And these are the only restrictions which may validly be imposed by the regulations.

In supporting the validity of its view of these Regulations, the majority of the Tax Court below apparently relied on the doctrine of statutory reenactment. However, as stated in the dissent below:

> "The principle of statutory reenactment is a rule of statutory construction and must be indulged in to find

11. The District Court in Ohio was describing §303(a)(1) of the Revenue Act of 1926 and §403(a) of the Revenue Act of 1934 which were, in pertinent part, identical to §202(a)(1) of the Revenue Act of 1916.

that Congress, by enacting section 2053(a)(2) of the Internal Revenue Code of 1954, intended to incorporate therein section 81.35 of Regs. 105 (not materially different from section 20.2053-3(d)(2), Estate Tax Regs.). The committee reports for the Internal Revenue Code of 1954 reflects no consideration of section 81.35 of Regs. 105." (R, 92a to 93a).

In 1954 Congress considered *only* the limitation of the state law in enacting section 2053(a)(2). In such a situation, the 1954 reenactment is without significance as to the validity of the Regulations. *United States* v. *Calamaro,* 354 U.S. 351, 359 (1957).

In its opinion below, the Tax Court indicated that its basic decisional authority for upholding the validity of its reading of Regulations §20.2053-3(d)(2) was *Estate of Christine Swayne,* 43 T.C. 190 (1964). As the dissent below properly points out, however, "[n]othing in that opinion indicates that the validity of the regulations was challenged. The Court did not state that the regulations were valid." (R, 94a to 95a). Moreover, in order to arrive at its decision, the *Swayne* court erroneously distinguished away *Estate of Louis Sternberger,* 18 T.C. 836 (1952), on the basis that the necessity of the sale at issue in *Sternberger* was not determined. In fact, the *Sternberger* case is squarely in point.

In *Sternberger,* decedent's will provided that his wife and daughter were given the right to occupy a residence owned by him. When they chose to live elsewhere, the property was sold by the executors. Contrary to the suggestion in *Swayne,* the Tax Court specifically found that the proceeds of the sale were not needed to pay debts or

expenses. However, the state court in *Sternberger* found the expenses of selling the house to be administration expenses under New York law, and accordingly the Tax Court held: "Since these expenses were administration expenses allowed by the laws of New York where the estate is being administered, the deduction is allowed." 18 T.C. at 843.

As the commissions paid the Gallery were properly allowable administration expenses under New York law, and as they were allowed by the Surrogate's Court in each of five judicial accountings, they were clearly deductible under section 2053.

Conclusion

The Estate is entitled to a deduction for the full amount of the commissions paid the Gallery. Accordingly, the decision of the Tax Court should be reversed and the case remanded.

Respectfully submitted,

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July 8, 1974.

ADDENDUM

The Statutes and Regulations Discussed in Appellants' Brief

Internal Revenue Code of 1954 (Title 26 U.S.C.)

Section 2053. EXPENSES, INDEBTEDNESS, AND TAXES

(a) GENERAL RULE.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

(1) for funeral expenses,

(2) for administration expenses,

(3) for claims against the estate, and

(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

Treasury Regulations

Deduction of Administration Expenses, Claims, Etc. (General)

§20.2053-1 Deductions for expenses, indebtedness, and taxes; in general—(a) *General Rule.* In determining the taxable estate of a decedent who was a citizen or resident of the United States at the time of his death, there are allowed as deductions under section 2053(a) and (b) amounts falling within the following two categories (subject to the limitations contained in this section and in §§20.2053-2 through 20.2053-9):

(1) *First category.* Amounts which are payable out of property subject to claims and which are allowable by the law of the jurisdiction, whether within or without the United States, under which the estate is being administered [,] for—

(i) Funeral expenses;

(ii) Administration expenses;

(iii) Claims against the estate (including taxes to the extent set forth in §20.2053-6 and charitable pledges to the extent set forth in §20.2053-5); and

(iv) Unpaid mortgages on, or any indebtedness in respect of, property, the value of the decedent's interest in which is included in the value of the gross estate undiminished by the mortgage or indebtedness.

As used in this subparagraph, the phrase "allowable by the law of the jurisdiction" means allowable by the law governing the administration of decedents' estates. The phrase has no reference to amounts allowable as deductions under a law which imposes a State death tax. See further §§20.2053-2 through 20.2053-7.

(2) *Second category.* Amounts representing expenses incurred in administering property which is included in the gross estate but which is not subject to claims and which—

(i) Would be allowed as deductions in the first category if the property being administered were subject to claims; and

(ii) Were paid before the expiration of the period of limitation for assessment provided in section 6501.

See further §20.2053-8.

(b) *Provisions applicable to both categories*—(1) *In general.* If the item is not one of those described in paragraph (a) of this section, it is not deductible merely because payment is allowed by the local law. If the amount which may be expended for the particular purpose is limited by the local law, no deduction in excess of that limitation is permissible.

(2) *Effect of court decree.* The decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends. If the court does not pass upon those facts, its decree will, of course, not be followed. For example, if the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing the validity and amount of the claim. However, the decree will not necessarily be accepted even though it purports to decide the facts upon which deductibility depends. It must appear that the court actually passed upon the merits of the claim. This will be presumed in all cases of an active and genuine contest. If the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by

proof to the contrary. If the decree was rendered by consent, it will be accepted, provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character, and was so accepted, if given by all parties having an interest adverse to the claimant. The decree will not be accepted if it is at variance with the law of the State; as, for example, an allowance made to an executor in excess of that prescribed by statute. On the other hand, a deduction for the amount of a bona fide indebtedness of the decedent, or of a reasonable expense of administration, will not be denied because no court decree has been entered if the amount would be allowable under local law.

(3) *Estimated amounts.* An item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. If the amount of a liability was not ascertainable at the time of final audit of the return by the district director and, as a consequence, it was not allowed as a deduction in the audit, and subsequently the amount of the liability is ascertained, relief may be sought by a petition to the Tax Court or a claim for refund as provided by sections 6213(a) and 6511, respectively.

• • •

Administration Expenses

§20.2053-3 Deduction for expenses of administering estate—(a) *In general.* The amounts deductible from a decedent's gross estate as "administration expenses" of the first category (see paragraphs (a) and (c) of §20.2053-1)

are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses. Each of these classes is considered separately in paragraphs (b) through (d) of this section.

(b) *Executor's commissions.* * * *

(c) *Attorney's fees.* * * *

(d) *Miscellaneous administration expenses.* (1) Miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in preserving and distributing the estate are deductible, including the cost of storing or maintaining property of the estate, if it is impossible to effect immediate distribution to the beneficiaries. Expenses for preserving and caring for the property may not include outlays for additions or improvements; nor will such expenses be allowed for a longer period than the executor is reasonably required to retain the property.

(2) Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the

decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution. The phrase "expenses for selling property" includes brokerage fees and other expenses attending the sale, such as the fees of an auctioneer if it is reasonably necessary to employ one. Where an item included in the gross estate is disposed of in a bona fide sale (including a redemption) to a dealer in such items at a price below its fair market value, for purposes of this paragraph there shall be treated as an expense for selling the item whichever of the following amounts is the lesser: (i) the amount by which the fair market value of the property on the applicable valuation date exceeds the proceeds of the sale, or (ii) the amount by which the fair market value of the property on the date of the sale exceeds the proceeds of the sale. The principles used in determining the value at which an item of property is included in the gross estate shall be followed in arriving at the fair market value of the property for purposes of this paragraph.

New York Estates, Powers and Trusts Law

SECTION 11-1.1 FIDUCIARIES' POWERS.—(a) As used in this section, unless the context or subject matter otherwise requires, (1) the term "estate" means the estate of a decedent; (2) the term "trust" means any express trust of property, created by a will, deed or other instrument, whereby there is imposed upon a trustee the duty to administer property for the benefit of a named or otherwise described income or principal beneficiary or both. A trust shall not include trusts for the benefit of creditors, resulting or constructive trusts, business trusts where certificates of beneficial interest are issued to the beneficiary, investment trusts, voting trusts, security instruments such as deeds of trust and mortgages, trusts created by the judgment or decree of a court, liquidation or reorganization

trusts, trusts for the sole purpose of paying dividends, interest, interest coupons, salaries, wages, pensions or profits, instruments wherein persons are mere nominees for others, or trusts created in deposits in any banking institution or savings and loan institution; (3) the term "fiduciary" means administrators, executors, preliminary executors, administrators d.b.n., administrators c.t.a. d.b.n., administrators c.t.a., ancillary executors, ancillary administrators, ancillary administrators c.t.a. and trustees of express trusts, including a corporate as well as a natural person acting as fiduciary, and a successor or substitute fiduciary, whether designated in a trust instrument or otherwise.

(b) In the absence of contrary or limiting provisions in the court order or decree appointing a fiduciary, or a subsequent order or decree, the will, deed or other instrument, every fiduciary is authorized:

• • •

(5) With respect to any property or any estate therein owned by an estate or trust, except where such property or any estate therein is specifically disposed of:

• • •

(B) To sell the same at public or private sale, and on such terms as in the opinion of the fiduciary will be most advantageous to those interested therein.

• • •

(23) In addition to those expenses specifically provided for in this paragraph, to pay all other reasonable and proper expenses of administration from the property of the estate or trust, including the reasonable expense of obtaining and continuing his bond and any reasonable counsel fees he may necessarily incur.

New York Surrogate's Court Act

§222. Payment of expenses incurred by representative.

An executor, administrator, guardian or testamentary trustee may pay from the funds or estate in his hands, from time to time, as shall be necessary, his legal and proper expenses of administration necessarily incurred by him, including the reasonable expense of obtaining and continuing his bond and the reasonable counsel fees necessarily incurred in the administration of the estate. Such expenses and disbursements shall be set forth in his account when filed, and settled by the surrogate.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

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ESTATE OF DAVID SMITH, Deceased, IRA M. LOWE, CLEMENT GREENBERG, ROBERT MOTHERWELL, Co-executors,

Petitioners-Appellants,

-against-

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

74-1617

- x

STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

GEORGE A. SCHOLZE, being duly sworn, deposes and says that he is an attorney associated with Sullivan & Cromwell, co-attorneys for Petitioners-Appellants Estate of David Smith; that on the 8th day of July, 1974 he served one (1) copy of Appendix and three (3) copies of brief in the above entitled action upon George Wolf, Esq., by depositing true copies of the same securely enclosed in a postpaid wrapper in the Post-Office Box regularly maintained by the United States Government at The Wall Street Station, Borough of Manhattan, City and State of New York, directed to said George Wolf, Esq., Tax Division, Department of Justice, Washington, D.C. 20530.

George A. Scholze

Sworn to before me this
8th day of July, 1974

Eileen L. Franklyn
Notary Public

EILEEN L. FRANKLYN
NOTARY PUBLIC, STATE OF NEW YORK
No. 31-1303130
Qualified in New York County
Commission expires March 30, 1976